

No. 12,117

IN THE
United States Court of Appeals
For the Ninth Circuit

SOUTHERN PACIFIC COMPANY (a corporation),

Appellant,

vs.

HAROLD BERLINER, former Collector of
Internal Revenue for the First Col-
lection District of California,

Appellee.

On Appeal from the United States District Court for the
Northern District of California.

BRIEF FOR APPELLEE.

THERON LAMAR CAUDLE,

Assistant Attorney General,

ELLIS N. SLACK,

MELVA M. GRANAY,

Special Assistants to the Attorney General,

FRANK J. HENNESSY,

United States Attorney,

E. ELMER COLLETT,

Assistant United States Attorney,

Post Office Building, San Francisco 1, California,

Attorneys for Appellee.

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BRIEF FOR APPELLEE.

OPINION BELOW.

The opinion of the District Court (R. 72-77) is not yet reported.

JURISDICTION.

This appeal involves a claim for refund of documentary stamp tax in the amount of \$46,687.95 with interest. (R. 79-80.) The tax was paid under protest to the appellee on or about February 26, 1943.

(R. 66.) Claim for refund was timely filed on or about June 11, 1943 (R. 66), and was rejected by the Commissioner of Internal Revenue on March 9, 1944. (R. 66-67.) Suit for refund was filed in the District Court on or about February 9, 1946 (R. 17), conformably with Section 3772 of the Internal Revenue Code. The District Court had jurisdiction of the case under Section 24, Fifth, of the Judicial Code, now 28 U. S. C., Section 1340. The judgment of the District Court was entered October 29, 1948. (R. 81-82.) Notice of appeal was filed November 26, 1948 (R. 82), conformably with 28 U. S. C., Section 1291, upon which the jurisdiction of this Court rests.

QUESTION PRESENTED.

Whether taxpayer incurred original issue tax under Section 1802(a) of the Internal Revenue Code when it issued 3,772,763.0564 shares of no par value stock in exchange for the like number of outstanding shares of \$100 par value stock and transferred \$6,304,845 from its "premium on Capital Stock" account to "Capital Stock" account.

STATUTES AND REGULATIONS INVOLVED.

Internal Revenue Code:

SEC. 1800. IMPOSITION OF TAX.

There shall be levied, collected, and paid, for and in respect of the several bonds, debentures,

or certificates of stock and of indebtedness, and other documents, instruments, matters, and things mentioned and described in sections 1801 to 1807, inclusive, * * * the several taxes specified in such sections.

(26 U.S.C. 1946 ed., Sec. 1800.)

SEC. 1802. CAPITAL STOCK (AND SIMILAR INTERESTS).

(a) [As amended by Section 1 of the Revenue Act of 1939, c. 247, 53 Stat. 862] *Original Issue*.—On each original issue, whether on organization or reorganization, of shares or certificates of stock, or of profits, or of interest in property or accumulations, by any corporation * * * holding or dealing in any of the instruments mentioned or described in this subsection or section 1801 * * *, on each \$100 of par or face value or fraction thereof of the certificates issued by such corporation * * * (or of the shares where no certificates were issued), 10 cents until July 1, 1941, and 5 cents thereafter; *Provided*, That where such shares or certificates are issued without par or face value, the tax shall be 10 cents until July 1, 1941, and 5 cents thereafter, per share * * *, unless the actual value is in excess of \$100 per share; in which case the tax shall be 10 cents until July 1, 1941, and 5 cents thereafter, on each \$100 of actual value or fraction thereof of such certificates (or of the shares where no certificates were issued), or unless the actual value is less than \$100 per share, in which case the tax shall be 2 cents until July 1, 1941, and 1 cent thereafter, on each \$20 of actual value, or fraction thereof, of such certificates (or of the shares where no certificates

were issued). The stamps representing the tax imposed by this subsection shall be attached to the stock books or corresponding records of the organization and not to the certificates issued.

* * * * *

(26 U.S.C. 1946 ed., Sec. 1802.)

Treasury Regulations 71 (1941 ed.), promulgated under the provisions of the Internal Revenue Code relating to stamp taxes:

SEC. 113.24. ISSUES SUBJECT TO TAX.

The following are examples of issues subject to the tax:

* * * * *

(d) Stock issued as a dividend and fractional script certificates.

* * * * *

SEC. 113.25. ISSUES NOT SUBJECT TO TAX.

In addition to the various issues specifically exempt under section 1808, as to which see Subpart J, the following are examples of issues not subject to the tax:

* * * * *

(f) The issue of stock in a recapitalization or reorganization where there is no dedication of additional capital, either by transfer of earned surplus or otherwise.

STATEMENT.

The facts, which were stipulated (R. 49-71), may be summarized as follows:

Taxpayer is a Delaware corporation having its principal office in San Francisco, California. Prior to September 30, 1947, it existed as a Kentucky corporation and was engaged in business in interstate commerce as a common carrier by rail. Between January 1, 1943, and March 31, 1945, the appellee was the duly, appointed, qualified and acting United States Collector of Internal Revenue for the First Internal Revenue District of California. He is not now in office as such collector but is a resident of the State of California and of the Southern Division of the United States District Court for the Northern District of California. (R. 49-50.)

Between the date of its incorporation as a Kentucky corporation and April 23, 1940, taxpayer¹ issued and had outstanding on that date 3,772,763.0564 shares of capital stock having a par value of \$100 a share, of which 3,562,606.0564 shares were issued at par and 210,157 shares were issued at a premium of \$6,304,845 over par. A substantial part of this stock was issued during periods when federal stamp taxes on the issuance of capital stock were in effect, and on all such parts of its outstanding capital stock

¹For convenience, the word "taxpayer" will be used to refer to both the Kentucky and Delaware corporations. While the case involves the tax liability of the Kentucky corporation, the Delaware corporation was substituted in the District Court as party plaintiff. (R. 46-48.)

taxpayer duly paid the federal stamp taxes then in effect. (R. 50.)

In April, 1940, taxpayer's articles of incorporation were amended to provide for changing the capital stock from par value to no par value shares. An even exchange was effected with the par value shareholders, 3,772,763.0564 shares of no par value stock being issued and exchanged for the 3,772,763.0564 shares of the \$100 par value stock then outstanding. No new money was paid in and no property was transferred to taxpayer in connection with this issuance and exchange of stock. (R. 50-51.)

Prior to the exchange of stock taxpayer's balance sheet for March 31, 1940, showed its stock account as follows (R. 61):

Stock	
751. Capital Stock	\$377,276,305.64
753. Premium on Capital Stock	6,304,845.00
<hr/>	
Total Stock	\$383,581,150.64

Prior to the exchange of stock, taxpayer's stock account was also shown in identical form in its annual report to the Interstate Commerce Commission, except that the figures in cents were not shown. (R. 62.)

The Subaccount 751, entitled "Capital Stock", represented the total par value of taxpayer's capital stock. (R. 62.) The Subaccount 753, entitled "Premium on Capital Stock", represented the excess over par received by taxpayer upon the issuance of 210,157

shares of its capital stock under the following circumstances (R. 62-64):

In 1909 certain bonds were issued by taxpayer which gave the holders thereof the privilege of converting their bonds into paid-up shares of taxpayer's common stock at the rate of \$130 par value of bonds for each \$100 par value of stock, on or before June 1, 1919. Up to January 9, 1912, \$662,090 par value of such bonds were surrendered and taxpayer issued in place thereof 5,093 shares of its \$100 par value capital stock. The par value of the stock was entered in the "Capital Stock" Subaccount and the excess of the par value of the bonds over the par value of the stock, namely, \$152,790, was entered in the "Premium on Capital Stock" Subaccount. There was no law taxing the original issue of certificates of stock when this conversion was made, so that no tax was payable on the original issue of these 5,093 shares.

In 1919 bonds of a par value of \$26,657,150 were turned in and taxpayer issued in place thereof 205,055 shares of its capital stock, each share having a par value of \$100. The par value of the stock was entered in the "Capital Stock" Subaccount and the excess of the par value of the bonds over the par value of the stock, namely, \$6,151,650, was credited to the "Premium on Capital Stock" Subaccount. In accordance with law, revenue stamps at the rate of five cents on each \$100 of par value of the 205,055 shares of \$100 par value stock were purchased by taxpayer and attached to the stock books.

In 1929 taxpayer issued certain bonds which had warrants attached thereto entitling the owners thereof to purchase on or before May 1, 1934, three shares of taxpayer's \$100 par value of stock at \$145 a share, plus adjustment of accrued dividends. A total of nine shares of taxpayer's stock was purchased pursuant to this arrangement in 1930 for a total price of \$1,305. The par value of the stock was entered in the "Capital Stock" Subaccount and the excess of \$405 over par was credited to the "Premium on Capital Stock" Subaccount. The correct amount of federal revenue stamps applicable to the original issue of these nine shares was affixed to the stock books of taxpayer at the time these nine shares were issued.

After the exchange of no par value stock for the \$100 par value stock in 1940, taxpayer's stock account, as shown in its balance sheet for April 30, 1940, was carried as follows (R. 64):

Stock	
751. Capital Stock	\$383,581,150.64
753. Premium on Capital Stock
<hr/>	
Total Stock	\$383,581,150.64

Taxpayer's stock account, subsequent to the exchange, was also shown in identical form in its annual report to the Interstate Commerce Commission for 1940, except that the figures in cents were not shown. Thus, the "Premium on Capital Stock" total of \$6,304,845 was transferred and added to the "Capital Stock"

account of \$377,276,305.64, making the "Capital Stock" account total of \$383,581,150.64. (R. 64-65.)

No original issue tax was ever paid with respect to the amount of \$6,304,845 transferred from "Premium on Capital Stock" account to the "Capital Stock" account other than that which taxpayer seeks to recover in this action. (R. 65.)

The Commissioner of Internal Revenue, by letter dated July 15, 1942, addressed to Internal Revenue Agent R. C. Cannedy at Los Angeles, California, ruled that, as the result of the change of taxpayer's stock from \$100 par value shares to no par value shares, the original issue stamp tax became due under Section 1802(a) of the Internal Revenue Code. It was held by the Commissioner that, by reason of the transfer of the \$6,304,845 from Subaccount 753, "Premium on Capital Stock," to Subaccount 751, "Capital Stock," additional capital in that amount was dedicated to the capital account; that this amount represented capital with respect to which no previous issue stamp tax had ever been paid; and that the tax was due with respect to the full amount of \$383,581,150.64 in taxpayer's "Capital Stock" Subaccount 751 because "the new capital and the old capital were intermingled in such a way that it cannot be said that the increase in the Capital Stock Account can be allocated to specific shares." Demand was made upon taxpayer for payment of the issue stamp tax with respect to the entire amount in "Capital Stock" Subaccount 751 following the change to no par shares. Taxpayer subse-

quently paid the tax in the amount of \$46,687.95 to appellee under protest, filed a claim for refund which was rejected, and instituted suit for refund in the District Court. (R. 65-67.)

The District Court held that taxpayer incurred original issue stamp tax in the amount of \$46,687.95 under Section 1802 of the Internal Revenue Code and denied recovery to taxpayer. (R. 72-77; 79-80.) The District Court's findings of fact include the following (R. 78-79):

5. At the time of and in connection with the exchange of the stock the plaintiff added the amount of \$6,304,845 to the capital stock account and thereby increased it to \$383,581,150.64.

6. The amount of \$6,304,845 was additional capital and no original issue tax was ever paid with respect to that amount.

7. When the amount of \$6,304,845 was transferred to the capital stock account and the new shares were issued, there was no allocation of specific shares to such transferred amount, each share represented both old and new capital and the new capital was so intermingled with the old capital that it is impossible to identify any part thereof with any of the new shares.

SUMMARY OF ARGUMENT.

The documentary stamp tax imposed by Sections 1800 and 1802(a) of the Internal Revenue Code is on shares of stock constituting an original issue. An

original issue includes shares issued in exchange for other shares, as here, if the exchange is accompanied by an increase in capital, that is, of capital as distinguished from surplus. In the present case taxpayer issued no par value shares in exchange for \$100 par value shares and transferred \$6,304,845 from its "Premium on Capital Stock" account to "Capital Stock" account. Prior to its transfer, the \$6,304,845 constituted paid-in surplus available for dividends. Thus, its transfer to "Capital Stock" account on issuance of the no par value shares in exchange for par value shares resulted in an increase in capital and an original issue of stock subject to tax under Sections 1800 and 1802(a).

Taxpayer's arguments in avoidance of the tax are all without merit. The pertinent Treasury Regulations support rather than refute the conclusion that taxpayer is liable for the tax. Although taxpayer asserts the contrary, its action in transferring the \$6,304,845 of paid-in surplus to "Capital Stock" account was effectual and binding on taxpayer under Kentucky law. Similarly, taxpayer is not relieved from the tax because it might not have made the transfer to "Capital Stock" account had not the rules of the Interstate Commerce Commission required it. Taxpayer's liability for tax is based on what it did, not on what it might have done, and the fact that the transfer was made in compliance with rules of the Interstate Commerce Commission does not change the realities of what taxpayer did.

ARGUMENT.

THE EXCHANGE OF TAXPAYER'S \$100 PAR VALUE STOCK FOR NO PAR VALUE STOCK, ACCOMPANIED BY A TRANSFER OF \$6,304,845 FROM "PREMIUM ON CAPITAL STOCK" ACCOUNT TO "CAPITAL STOCK" ACCOUNT, WAS AN ORIGINAL ISSUE OF SHARES OF STOCK AND SUBJECT TO TAX UNDER SECTIONS 1800 AND 1802(a) OF THE INTERNAL REVENUE CODE.

Under Sections 1800 and 1802(a) of the Internal Revenue Code (*supra*), documentary stamp tax is imposed "On each original issue, whether on organization or reorganization, of shares or certificates of stock, * * * by any corporation * * *." If the capital of a corporation is increased upon an issuance of stock, the stock constitutes an "original issue" and this is true even though the new stock may merely be exchanged for previously issued stock. *Rio Grande Oil Co. v. Welch*, 101 F. 2d 454 (C.A. 9th); *W. T. Grant Co. v. Duggan*, 94 F. 2d 859 (C.A. 2d); *American Gas & Electric Co. v. United States*, 69 F. Supp. 614 (S.D. N.Y.); *Ohio State Life Ins. Co. v. Busey*, 56 F. Supp. 410 (S.D. Ohio); cf. Treasury Regulations 71 (1941 ed.), Section 113.25(f), *supra*. An increase in capital means an increase in capital in the narrow sense in which the word "capital" is distinguished from "surplus". *Ibid*. The tax is on the certificates of stock measured by the value of the certificates and not on the amount of the increase in capital. *American Gas & Electric Co. v. United States*, *supra*. Accordingly, an entire new issue is taxable unless definite shares can be identified as having been issued against the increase in capital. *Rio Grande Oil Co. v. Welch*, *supra*; *W. T. Grant Co. v. Duggan*, *supra*;

American Gas & Electric Co. v. United States, supra. On the other hand, the issuance of new certificates of stock in exchange for previously issued shares may result in only a "reissue", nontaxable under Section 1802(a), if the issue is not accompanied by any increase in capital.²

In the present case no par value shares of stock were issued by taxpayer in 1940 in place of shares having a par value of \$100 a share and the issuance of the no par value shares was accompanied by a transfer of \$6,304,845 from "Premium on Capital Stock" account to "Capital Stock" account. Taxpayer's contention, which we submit is without merit, is that the transfer of the \$6,304,845 from "Premium on Capital Stock" account to "Capital Stock" account did not result in an increase in capital and that consequently, the no par value shares were a "reissue" rather than an "original issue".

The transfer of the \$6,304,845 from "Premium on Capital Stock" account to "Capital Stock" account was, however, an increase in and dedication of capital. The net worth of a corporation is divided for book-keeping purposes into two parts, capital and surplus.

²*Edwards v. Wabash Ry. Co.*, 264 Fed. 610 (C.A. 2d); *American Laundry Machinery Co. v. Dean*, 292 Fed. 620 (S.D. Ohio); *Trumbull Steel Co. v. Routzahn*, 292 Fed. 1009 (N.D. Ohio); *West Virginia Pulp & Paper Co. v. Bowers*, 293 Fed. 144 (S.D. N.Y.), affirmed per curiam, 297 Fed. 225 (C.A. 2d), certiorari denied, 265 U. S. 584; *Standard Mfg. Co. v. Heiner*, 300 Fed. 252 (W.D. Pa.); *Goodyear Tire & Rubber Co. v. United States*, 60 C. Cls. 448; *Cuba R. Co. v. United States*, 60 C. Cls. 272; *In re Grant-Lees Gear Co.*, 1 F. 2d 393 (N.D. Ohio); *Cleveland Provision Co. v. Weiss*, 4 F. 2d 408 (N.D. Ohio); *United States v. Pure Oil Co.*, 135 F. 2d 578 (C.A. 7th).

The amount placed in capital must be equal to the aggregate par value of all issued shares of par value stock, while the remainder is surplus. Grange, Corporation Law for Officers and Directors (1935), p. 243. Stated another way, "surplus" is the excess in the value of assets treated by the corporation as part of its *permanent* capital. *Peake v. Thomas*, 222 Ky. 405, 407. The excess over par received as a premium on the sale of stock constitutes "paid-in surplus" and is properly credited to a "Paid-in Surplus" account or "Capital Stock Premium" account. Graham and Katz, Accounting in Law Practice (2d ed., 1938), p. 135; Grange, *supra*, pp. 243-244; Paton, Accountants' Handbook (2d ed., 1937), p. 963. This is true in Kentucky, for the Supreme Court of Kentucky stated in *Lewis, Secretary of State v. Oscar C. Wright Co.*, 234 Ky. 814, 816, that:

* * * our corporation laws do not expressly provide for the sale of par stock at a price above par so as to create a paid-in surplus; yet that practice has been indulged in for many years, and has been recognized as a proper and safe method of financing a corporation. * * *

In the instant case, taxpayer, a Kentucky corporation at the time, received \$6,304,845 in excess of par on the sale of stock and this amount was properly carried in a "Premium on Capital Stock" account prior to the issuance of no par value stock. It constituted paid-in surplus which, in the absence of explicit statutory restrictions, is very widely assumed in practice to be available for the payment of dividends. Graham and

Katz, *supra*, p. 152; Grange, *supra*, p. 244; Mitchell, Capitalization of Corporations Issuing Shares Without Par Value, 11 A.B.A.J. 377, 380 (1925). Under the statutes of Kentucky, paid-in surplus may be used for dividends and taxpayer makes no contention to the contrary.³ In contrast, the \$100 par value of taxpayer's outstanding stock was carried in "Capital Stock" account, in the aggregate amount of \$377,276,-305.64. This was taxpayer's capital—the amount which was legally segregated or fixed in the corporate business so that it could not be withdrawn for distribution

³As taxpayer states (Br. 26-27), the only prohibition against the declaration and payment of dividends under Kentucky corporation law is that set forth in Section 548 of the Kentucky statutes (Carroll's Kentucky Statutes Annotated (Baldwin's 1936 rev.), c. 32), now Section 271.265 of the Kentucky Revised Statutes (1948), which prohibits the declaration and payment of a dividend the payment of which would render the corporation insolvent "or which would diminish the amount of its capital stock". In *Haggard v. Lexington Utilities Co.*, 260 Ky. 261, 268, it was stated that:

Section 548 does not prohibit the payment of dividends out of surplus or any other fund when such payment will not render the corporation insolvent or diminish the amount of its capital stock. * * *

That case also makes it clear that the prohibition against diminution of the amount of capital stock has reference to capital stock account only, not to capital stock account together with paid-in surplus. There the capital stock of the corporation had become impaired to the extent of approximately \$1,700,000 by reason of losses sustained on an investment. Because of Section 548 of the Kentucky statutes, no dividend could be paid although the corporation's earnings were sufficient for that purpose. To meet this situation an amendment to the articles of incorporation was adopted to reduce the capital stock of the corporation. The reduction of the capital stock of course resulted in the creation of paid-in surplus, which includes surplus arising from a recapitalization. Paton, *supra*, p. 931. It was held that the amendment to the articles of incorporation was properly adopted and that dividends could properly be paid after the reduction of capital stock "out of surplus or any other fund" (p. 268), there then being no impairment of capital stock.

to stockholders. Grange, *supra*, pp. 112, 113. Thus, when taxpayer in 1940 issued no par value stock in place of stock having a par value of \$100 a share and transferred the \$6,304,845 of paid-in surplus (carried in the "Premium on Capital Stock" account) to "Capital Stock" account, there was an increase in capital and, accordingly, the no par value shares constituted an "original issue" taxable under Section 1802(a).

While the account or accounts carried by taxpayer on its books under the heading of "Surplus Account" were not affected by the issuance of the no par value stock in 1940, taxpayer's repeated assertions that the issuance of the stock did not change its surplus account (Br. 16-17, 26) must be considered in connection with the nature of the "Premium on Capital Stock" account. Since that account was actually a paid-in surplus account, as we have shown, and the amount thereof, \$6,304,845, was transferred to the "Capital Stock" account upon issuance of the no par value shares, the transfer of the \$6,304,845 to the "Capital Stock" account was in fact a transfer of surplus to capital.

Contrary to an argument made by taxpayer (Br. 27-35), the no par value stock issue was not exempt from tax under Treasury Regulations 71 (1932 ed.), Article 29(i). That regulation gives the following as an example of an issue of stock not subject to tax:

- (i) The issue by a corporation of certificates of stock in exchange for outstanding certificates of its own stock where such exchange is effected

without the capital of the corporation being increased, either by transfer of surplus to capital account or otherwise.

Treasury Regulations 71 (1941 ed.), which superseded Treasury Regulations 71 (1932 ed.), state the same example in Section 113.25 (f) as follows:

(f) The issue of stock in a recapitalization or reorganization where there is no dedication of additional capital, either by transfer or earned surplus or otherwise.

Taxpayer's contention is that these provisions should be interpreted as exempting from tax an issue of stock where the only increase in capital results from a transfer of *paid-in* surplus to capital stock account—that the tax is to be imposed only where there is a transfer of *earned* surplus to capital stock account. (Br. 28, 31-33.) The emphasis in the Regulations, however, is on the absence of an increase in capital *by any method whatever*. That the Regulations were not intended to exempt from tax an issue which is accompanied by an increase in capital by way of a transfer of paid-in surplus to capital stock account is evident from the fact that Treasury Regulations 71 (1932 ed.), Article 28 (e), and Treasury Regulations 71 (1941 ed.), Section 113.24(d), *supra*, respectively, cite "Stock dividend" and "Stock issued as a dividend" as an example of an issue which *is* subject to tax. On the issuance of a stock dividend there is necessarily an increase in capital (*Eisner v. Macomber*, 252 U.S. 189, 210-211) and in most states a stock

dividend may be issued against paid-in surplus. When it is, the stock issue is an original issue, obviously, and taxable under the Regulations. Thus, so long as no shares have been issued against paid-in surplus, the issuance of new shares against it, whether as a stock dividend attributable to specific shares or as an entire new issue against which the old capital and new capital, consisting of paid-in surplus, are commingled, the stock is an original issue and nothing in the Regulations precludes that conclusion. This Court so assumed in *Rio Grande Oil Co. v. Welch*, 101 F. 2d 454. In that case, where a stock issue was held to be an original issue and taxable under an identical predecessor of Section 1802 (a), there was no transfer of earned surplus; the "Value of Capital Stock Outstanding" account was simply increased by unrealized appreciation on certain assets, plus paid-in surplus.

Taxpayer is in error in urging (Br. 18-19) that the \$6,304,845 of paid-in surplus it transferred from "Premium on Capital Stock" account to "Capital Stock" account was tax-free, as having been received as a premium upon the sale of stock, and thus should not be considered as an increase in capital upon its transfer to "Capital Stock" account in 1940. It is true of course that tax was either paid or was not required to be paid on the \$100 par value certificates from the sale of which taxpayer realized the \$6,304,845 in excess of par value, but it does not follow that Congress intended the \$6,304,845 to be tax-free. Such tax as was paid upon the certificates from which taxpayer realized the aggregate premium of \$6,304,845

was paid upon the certificates on the basis of taxpayer's capital stock account as of that time, which included only the par value of the certificates. The later increase in capital by the transfer of the \$6,304,845 of paid-in surplus to "Capital Stock" account was of capital which had not been subjected to the issue tax and against which new shares could have been issued as a dividend. The increase in capital resulted in another original issue of stock and thus necessarily in tax liability under Section 1802 (a).⁴

There is also no merit in the argument of taxpayer (Br. 20-27) based upon Kentucky statutes. Taxpayer assumes that the transfer of the \$6,304,845 of paid-in surplus to "Capital Stock" account was an increase of "capital stock" within the meaning of Sections 553 and 564-1 of the Kentucky statutes (Carroll's Kentucky Statutes Annotated (Baldwin's 1936 rev.), c. 32); interprets both of these sections as requiring the filing of a statement or amendment to taxpayer's articles of incorporation as to the transfer of the \$6,304,845 to "Capital Stock" account; and argues that, since it filed no such statement or amendment, the

⁴Taxpayer places mistaken reliance upon a Bureau letter (Br. 33-34) stating that no tax was incurred on an exchange of stock accompanied by a transfer of \$94,658 from capital surplus account to capital stock account. The reason for that statement, as taxpayer's quotation of the letter shows, was that the amount of capital surplus involved had previously been a part of the capital stock account, subjected to the issue tax, created as capital surplus by a reduction in the capital stock account, and then, upon the stock issue in question, transferred back to the capital stock account. The present case involves no such set of facts.

The Treasury Regulations relating to income taxation upon which taxpayer relies (Br. 30-31) are also inapposite on their face.

transfer was ineffectual to increase its "Capital Stock" account. (Br. 24.) Section 553, but not Section 564-1 (see Br. 23-24), requires the filing of a statement as to an increase in capital stock. The failure to file the statement required by Section 553, which is to be filed "in the same manner as articles of incorporation," does not render an increase or decrease in capital stock void; the required statement is merely "for the benefit of the public; to protect the rights of creditors or those of the public dealing with the corporation." *Williams v. Davis*, 297 Ky. 626, 630. Moreover, it would appear that taxpayer's transfer of the \$6,304,845 to "Capital Stock" account was not an increase in "capital stock" within the meaning of Sections 553 and 564-1 of the Kentucky statutes and that, therefore, those sections are inapplicable with respect to the transfer. An increase in "capital stock" under those sections appears to mean an increase in the total *par value* of the authorized number of shares of stock. See *Haggard v. Lexington Utilities Co.*, 260 Ky. 261. The issuance of *no par value* shares is covered by Section 564-2 (Carroll's Kentucky Statutes Annotated, *supra*), which provides, *inter alia*, as follows:⁵

§ 564-2. *Stock without par value.*—Any corporation organized under this law may, if so provided in its certificate of incorporation or in an amendment thereof, issue shares of stock * * * without any nominal par value. * * * Such stock

⁵This statute as quoted on page 4 of the appendix to taxpayer's brief is inaccurate in that it omits the phrase "for such consideration as may be fixed from time to time."

may be issued by the corporation from time to time for such consideration as may be fixed from time to time by the board of directors thereof, pursuant to authority conferred in the certificate of incorporation, or if such certificate shall not so provide, then by the consent of the holders of two-thirds of each class of stock then outstanding and entitled to vote given at a meeting called for that purpose in such manner as shall be prescribed by the by-laws * * *.

Thus, no par value shares may be issued in place of par value shares only pursuant to amendment of the articles of incorporation, but the amount of the consideration received therefor, and thus the amount of capital placed in capital stock account, is strictly a matter within the discretion of the board of directors under proper authority from the stockholders. This discretion extends to a determination of what shall be capital and what paid-in surplus, for in *Lewis, Secretary of State v. Oscar C. Wright Co.*, 234 Ky. 814, it was held that, despite the absence of express statutory authority, the board of directors, which had the consent of the stockholders, could in their discretion allocate to paid-in surplus rather than to capital a portion of the consideration received for no par value shares, just as paid-in surplus may be created by a sale of par value stock above par. In the present case there was an increase in capital upon the exchange of the \$100 par value shares for no par value shares, but not an increase in authorized capital stock. An increase in capital, but not an increase in authorized capital stock, would also have resulted if taxpayer had declared a stock dividend based on a

transfer of the \$6,304,845 of paid-in surplus to "Capital Stock" account, but taxpayer would hardly contend that a statement of the transfer to "Capital Stock" account or an amendment of its articles of incorporation would be necessary to declare a stock dividend which would not increase its outstanding shares beyond its authorized capital stock.

Since the filing of a statement or amendment to taxpayer's articles of incorporation was not necessary to make effectual taxpayer's transfer of the \$6,304,845 of paid-in surplus to "Capital Stock" account either under Sections 553 and 564-1 of the Kentucky statutes, relied upon by taxpayer, or Section 564-2, *supra*, the transfer was valid and binding on taxpayer. The only other requirement under any of these statutes was that the transfer be made under authority conferred by stockholders representing two-thirds of the capital stock, after notice and a meeting for that purpose. Taxpayer's board of directors adopted a resolution providing, among other things, for a change in authorized capital stock from \$100 par value shares to no par value shares and the exchange of stock share for share (R. 56-58) "subject to the consent of the stockholders *and to authorization by the Interstate Commerce Commission,*" (italics supplied) (R. 56); for notice of and a meeting of the stockholders "for the purpose, among others, of voting upon the said amendment and the said change in capital stock *and authorizing action incidental thereto*" (italics supplied) (R. 57); and for application to the Interstate Commerce Commission for authority to cause to be issued in exchange for its par value common,

stock then outstanding 3,772,763.0564 shares of stock without nominal par value (R. 58). At the meeting of the stockholders duly called pursuant to this resolution of the board of directors, the stockholders passed a resolution stating, among other things, that (R. 60-61):

* * * the proper officers of the Company are authorized to take or cause to be taken all such action as may be necessary or required by law to make effective the said amendment changing the capital stock of this Company.

That the Board of Directors and proper officers of this Company are hereby authorized and empowered to take any and all action necessary or appropriate to carry out the effect and intent of said amendment and the issuance or substitution of stock as therein authorized, * * *

As taxpayer states (Br. 35-36), under the requirements of the Interstate Commerce Commission it was mandatory upon taxpayer, in changing its capital stock to no par value shares and exchanging such shares for the outstanding par value shares, to transfer the \$6,304,845 of paid-in surplus from "Premium on Capital Stock" account to "Capital Stock" account. In obtaining the authority of the Interstate Commerce Commission to the change, taxpayer recognized and apparently proposed the transfer of the \$6,304,845 to "Capital Stock" account, for the report of the Interstate Commerce Commission states (R. 68-69):

The applicant proposes to amend its articles of incorporation to change its authorized capital stock from shares with a par value of \$100 a

share to shares without nominal or par value, the number of authorized shares to remain unchanged. Of the total authorized shares, 3,722,763.0564 will be issued to the holders of the outstanding stock, upon the surrender of the outstanding certificates, on a share for share basis and will be entered in the applicant's capital stock account at \$383,581,150.64, representing the par value and premium on its outstanding stock. * * *

Hence, taxpayer's action in transferring the \$6,304,845 of paid-in surplus to "Capital Stock" account was both intentional and authorized by the stockholders as being necessary, appropriate, and required by law to make effective the amendment changing taxpayer's capital stock and for exchange of no par value shares for the outstanding \$100 par value shares. The transfer of the \$6,304,845 to "Capital Stock" account was therefore valid and binding on taxpayer.

The issue tax cannot be avoided by taxpayer on the ground that the transfer of the \$6,304,845 of paid-in surplus to "Capital Stock" account was made in compliance with rules of the Interstate Commerce Commission. As the District Court stated (R. 77), the fact that the transfer may have been required by the Interstate Commerce Commission "does not change the realities of the situation." Contrary to taxpayer's assertions (Br. 37-39), the transfer did not merely effect a change in description of nomenclature of the paid-in surplus previously carried in the "Premium on Capital Stock" account. As we have already shown, taxpayer intended to and, in conformance with the laws of Kentucky, did legally increase its "Capital Stock" account by the \$6,304,845 of paid-in surplus.

Accordingly, taxpayer is not relieved from tax liability simply because it *might not* have transferred the \$6,304,845 to "Capital Stock" account had it not been for the rules of the Interstate Commerce Commission. That conclusion is not in conflict with the statement in *Old Colony R. Co. v. Commissioner*, 284 U. S. 552, 562, that the Commissioner may not resort to accounting rules of the Interstate Commerce Commission for the determination of tax liability. Taxpayer's liability for the issue tax is based not upon mere book entries made under rules of the Interstate Commerce Commission but upon the substantive and legal effect of what taxpayer did.

CONCLUSION.

The decision of the District Court is correct and should be affirmed.

Dated, March 16, 1949.

Respectfully submitted,

THERON LAMAR CAUDLE,
Assistant Attorney General,

ELLIS N. SLACK,

MELVA M. GRANEY,

Special Assistants to the Attorney General,

FRANK J. HENNESSY,

United States Attorney,

E. ELMER COLLETT,

Assistant United States Attorney,

Attorneys for Appellee.

